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SUBJECT: THE GOF INTRODUCES ITS 2007 BUDGET

¶1. SUMMARY: French Finance Minister Breton unveiled the proposed budget for 2007, which includes tax cuts and measures to boost consumption (and please voters in a presidential election year). Spending priorities remain essentially unchanged from 2006: education, defense, safety, justice, employment and R&D. Based on forecasts of continuing economic growth, the budget also aims to reduce the overall budget deficit to 2.5 percent of GDP, and public debt to 63.6 percent of GDP. Economists see the 2.0-2.5 percent GDP growth forecast as too high. Opposition parties have contested the budget, notably the decrease in taxes, and demanded an audit. END SUMMARY.

Government Cuts Taxes to Improve Purchasing Power . . .

¶2. On September 27, Finance Minister Thierry Breton introduced the draft 2007 central government (CG) budget. He pledged more than 7 billion euros (9 billion dollars) in tax cuts, and rebates benefiting students, commuters, and lower-income wage-earners, all measures to buoy consumer spending and effective early 2007. A June poll had revealed that unemployment and purchasing power were among key concerns for the electorate. Breton said the tax cuts were designed to boost household purchasing power and fuel consumer spending, but claimed they were not linked to upcoming elections.

¶3. Income tax cuts are part of an overhaul that will reduce the number of tax brackets from seven to four with the top marginal rate cut from 48.09 percent to 40 percent. With the new measures, income tax cuts since 2002 have amounted to approximately 20 percent (versus the 33 percent pledged by President Chirac during the 2002 presidential campaign). The government also set a 60 percent ceiling ("bouclier fiscal") for the total tax imposed on an individual (excluding payroll taxes and social contributions), thereby helping indirectly to curb France's "wealth tax." Low-wage earners will benefit from a higher earned income tax credit (EITC), at a cost of 1 billion euros (1.3 billion dollars) to the budget. Budget Minister Jean-Francois Cope underlined that "a single person who is paid the minimum wage will start each month in 2007 with 130 euros more in his or her pocket than in 2002 thanks to tax cuts, increases in the SMIC, and the increase in the EITC."

¶4. The 2007 CG budget also cuts corporate taxes, notably by capping the professional tax (a tax paid to local authorities) to no more than 3.5 percent of value added, and by introducing measures in favor of small and fast growing companies. In order to find additional resources, the 2007 CG budget is reintegrating capital gains in the income tax base for sales of shares exceeding 22.8 million euros (29.2 million dollars). Below that limit a 5 percent tax will be levied on capital gains. (Note: This is not a major change for companies, since the corporate capital gain for shares

held for more than two years will disappear.) The CG budget projects tax receipts will rise to 225.9 billion euros (289.1 million USD) from 221.5 billion euros (283 billion USD).

. . .And Boost Economic Growth

¶5. Taking into account effects of tax measures on consumption and corporate investment, the government expects GDP growth between 2.0-2.5 percent in 2007, unchanged from this year and double 2005 growth. The government expects 250,000 new jobs to be created in 2007, mainly in the private sector, compared to the recent estimate of 260,000 created in 2006. Government forecasts assume the euro will trade at USD 1.28, up from the USD 1.25 used in the 2006 CG budget, and that oil will trade at USD 70 per barrel ("to maintain a security margin" according to Finance Minister Breton.) The government forecast is in line with the 2.3 percent IMF forecast, which nonetheless outlined risks from oil prices and a U.S. economic slowdown.

Reducing the Budget Deficit

¶6. A contrasting government concern is to reduce the CG budget deficit to 41.6 billion euros (53.3 billion USD) in 2007 from an estimated 42.7 billion euros in 2006, a figure sharply lower than the 46.9 billion set out in 2005. The 2007 CG budget deficit, the lowest since 2001, will meet the government objective of reducing the overall budget deficit (including CG, social security system, and local authorities). As part of this objective, the government plans to reduce the social security deficit to 8 billion euros (10.2 billion USD) in 2007 from 9.7 billion euros (12.4 billion USD) in 2006 (septel).

¶7. The government target is to reduce the overall budget deficit to 2.5 percent of GDP, well below the euro zone's Stability and Growth Pact limit of 3 percent of GDP. The government revised its deficit estimate for 2006 from 2.7 percent of GDP to 2.6 percent after stronger-than-expected GDP growth boosted tax receipts above forecasts. France had breached the limit of 3 percent of GDP between 2002 and 2004. The 2005 deficit went back under the limit, largely thanks to a one-time payment from utility EDF-GDF in exchange for the government having assumed pension liabilities.

Remedy is Cutting CG Budget Spending

¶8. To meet the deficit objective, 2007 CG spending would increase 0.6 percent to 267.8 billion euros from 266.1 billion euros. This is one percent less than the forecast inflation rate, following three years during which CG budget spending increased at the same pace as inflation. The government will rely on spending cuts, notably a reduction of 15,000 civil servant jobs by attrition, with over 7,000 reductions slated for the education system. Though the cut is modest given France's 2.3 million civil servants, it is twice as large as last year and represents the largest cut in 15 years. Breton stressed that the government objective was to spend money more efficiently ("doing better with less money") while modernizing the public service. To meet this objective, the government has launched 100 audits in various ministries to identify modernization plans aimed at increasing government productivity, improving public service and enhancing the use of new technologies.

Ultimate Goal is Reducing Public Debt as a Percent of GDP

¶9. The reduction in the overall budget deficit would allow the public debt to fall to 63.6 percent of GDP in 2007 from 66.6 percent in 2005, and 65.5 percent in the second quarter of 2006. Finance Minister Breton said the government would use any unexpected receipts to reduce the public debt as it did in 2006 with 5.1 billion euros (6.5 billion USD) in additional tax receipts. The government will sell 106.5 billion euros (136.3 billion USD) in bonds in 2007 after buying back 13.2 billion euros (16.9 billion USD) of 2007 and 2009 debt on proceeds from real estate asset sales. The government medium-term objective is to reduce debt as a percentage of GDP to 60 percent, the euro zone's Stability and Growth Pact limit, by 2010.

Government is Very Supportive of Its Budget

¶10. Breton hoped the European Commission would end an inquiry into

France's public finances, given its deficit and debt targets. He stated "we set a process in motion; our successors will have to follow the same direction."
Breton told reporters "our budget is solid; we are confident that we'll reach the 2.5-of-GDP budget deficit goal." Budget Minister Cope termed the 2007 CG budget a "good budget, beneficial to purchasing power, employment and debt reduction."

Economists Wonder about Future GDP Forecasts

¶11. Private-sector economists expressed concerns that government forecasts might be overly optimistic, due to signs of a U.S. slowdown and doubts about the economic strength of Germany, France's major trading partner. Morgan Stanley senior economist Eric Chaney forecast 1.9 percent GDP growth in 2007, expecting a fiscal tightening in Germany and Italy and the rise in short-term rates would affect French economic growth. He forecast the 2007 overall budget deficit to decrease to 2.7 percent of GDP. Xavier Timbeau, head of analysis at Paris-based think tank Observatoire Francais des Conjonctures Economiques remarked "the 2007 CG budget is not going to be easy to implement. Another question is whether the strength of tax receipts will remain the same as in 2006 or be back to normal." He concluded "to reduce the deficit requires both a strong slowdown of public spending and tax receipts rising faster than GDP growth, like this year."

Opposition Demands Audit

¶12. Eric Besson, an opposition socialist lawmaker in charge of economic issues said "the government is going to brag during the election campaign about its economic results, but it's going to bump into reality." The Socialist Party criticized the center-right's rosy picture of the economy, and stressed that the new president elected in June 2007 would not implement the budget. Budget Minister Cope replied that the government was ready for a complete audit of its budget, as demanded by Socialist Party leader Francois Hollande (who notably contested the decrease in taxes). Cope warned that Socialist proposals for 2007 would result in a surge of the budget deficit.

Comment

¶13. The 2007 CG budget looks coherent, with controlled budget spending, tax cuts for taxpayers and companies, and a decline in the public debt as a percent of GDP. However, it relies heavily on economic growth estimates. If GDP growth loses steam, the budget deficit would increase above the limit of 3 percent of GDP. More importantly, fiscal policy could be significantly altered by the result of the 2007 presidential elections. Despite recent efforts, French public finances have deteriorated since 2002. Reducing significantly the overall budget deficit will heavily depend on further cuts in spending, notably in the bloated civil service, and a reduction in social security spending. Both will be difficult to achieve politically.

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